Possibilities and Difficulties of Economic Value Added Use

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Abstract: - The development of world economy raises changes in enterprise financial management focus. Still more attention is devoted to enterprise value creation and management for shareholders. The target of the paper is mapping, identification, analysis and summary of main aspects and significance of Economic Value Added concept within enterprise performance measurement and management. The strengths and weaknesses of Economic Value Added (further just EVA) are analyzed and discussed in the context of economic development paradigm changes in the beginning of the 21st century. A part of the paper outputs is a case study which practically documents EVA concept use in enterprise practice.

Key-Words: - Economic Value Added, Economic Profit, Financial Performance, Value Based Management, WACC, NOPAT, Shareholder Value

1 Introduction
The end of the 20th century and mainly the beginning of the 21st century bring many new challenges for business community and also for public [12]. Business entities operating in globalized environment are exposed to turbulences of variable strength and intensity which often result in review of existing operations, activities and processes, offered assortment range, preferred target markets and customer segments. Among the main initiators supporting and extending this state undoubtedly belonged the economic crisis of the last decade followed by unusual decrease of real economy, public finance deficit, and significant drop of household and enterprise optimism. Only those enterprises, companies and institutions which were well managed, characterized by a well stated, implemented and corrected vision and from there deducted targets and strategies succeeded to withstand this mostly unfavorable period [29].

Keeping the current standards of key customers’ loyalty and acquiring every new customer is becoming still more difficult. Not only this places considerable demands on enterprises and their management in the 21st century. To observe and satisfy the current needs of key customer segments and to create new brings the need of long-term observation and regulating enterprise performance levels. The customers are still more demanding, they expect an individual approach, a wide range of offered goods and services, high quality and defectlessness of goods (from health and also environmental friendliness point of view), further on reliability, quick feedback, adequate sales prices and perfect service.

Despite the dispute about suitability of business targets alternative concepts applicability within the firm theory the target of business activity is still reaching maximal profit, not only in business entities which were founded for such purpose but also in non-profit organizations where the profit variables are not the primary goal. In the long term one of the ways how to achieve meeting the customers’ needs and how to reach maximal (or optimal) profit level as corresponding reward for businessmen (owners) for their risk-taking is to improve the enterprise financial management. On the operating level it corresponds for example with stabilization of enterprise cost level, making the enterprise processes, operations and activities more effective, keeping balanced budgets. On the tactical level of business management it is achieving sustainable performance and success, supplying the customers with as high added value as possible and on the strategic level the target is long-term competitiveness of the enterprise.

2 Problem Formulation
The end of the 20th century and the beginning of the 21st century are in the sign of changes not only on macro-level, also the enterprise micro-level
has been through changes in a lot of ways. The development and modern trends in enterprise performance issue, mainly methods, tools and measures of financial (economic) performance are referred to by [10], [11], [16], [17], [18], [23], [24], [25], [33], [34] as well as by other professionals from academic and private sector. The paper points out the disunity of enterprise performance definition, summarizes the existing development of methods and tools used for enterprise financial performance measurement and predicts the future directions in their use. Then it describes, identifies, analyses and summarizes the main aspects and importance of Economic Value Added concept within the enterprise performance measurement and management. The strengths and weaknesses of Economic Value Added are analyzed and discussed in the context of economic development paradigm changes in the beginning of the 21st century. A part of the paper outputs is a case study which practically documents EVA concept use in enterprise practice. The targets and results of the paper are achieved by qualitative research of literary and electronically processed sources of authors from and also out of the academic sector. Specifically they are mainly monograph publications, research reports, professional studies, papers and review articles in professionals magazines published to the enterprise financial performance topic, specifically to Value Based Management and Economic Value Added in national and international frame. The practical application of EVA concept and its use in financial management within the Value Based Management of enterprise is illustrated by the case study processed in the application part of the paper. The data and information about economic development were taken from a selected business entity which works in industrial production in the Czech Republic.

2.1 Financial performance of enterprise and its measurement and management methods and tools
The first problem which appears in context with the analysis of enterprise performance issue is its concept and content definition. The academic and the private sectors see the enterprise financial (economic) performance in different ways [5]. The fragmentation of terminology has been undoubtedly influenced by the wide range of users (inside and outside the enterprise) evaluating enterprise performance. Whether the enterprise performance is viewed as “the amount of results achieved by individuals, groups, organization and its processes” [22], as “the ability of a business entity to make the most of investments put in its business activities” [32] or “characteristic which describes the way or process how the researched subject does a certain activity based on the similarity to the reference method of executing (processing) this activity“ [34], the enterprise performance always has two interrelated dimensions. They are to “do the right things” in the sense of effectiveness and to “do the things right” in the sense of efficiency. Enterprise performance is generally characterized by better measurability than competitiveness of an enterprise, similarly as effectiveness and success of an enterprise [4]. In the last few decades a significant upturn of methods and tools for enterprise performance measuring and management has been documented by many updates of existing conceptions, methods and tools and formation of brand new ones. The list of the currently most used of them and the development of their use in enterprise practice in time are stated for example in the overview of Bain&Company [1]. On the basis of further research [17] Balanced Scorecard by authors Kaplan and Norton, methods and tools of Controlling and Management Accounting (e.g. Direct Costing, Variable Costing), Total Quality Management, Kaizen, Lean Management including Just-In-Time concept, Benchmarking, Six Sigma etc. belong to the most often applied conceptions, methods and tools for enterprise performance measuring and management. Business entities in the Czech Republic see a great potential in modern methods, Management Accounting tools (Activity Based Management), Continuous Improvement concept, reengineering of processes, etc. [19].

2.2 Value Based Management
Although the profit maximization is still seen as the enterprise economy primary target, the world economy development and associated phenomenons (e.g. internationalization tendency and capital markets deregulation, progress of information and communication technologies, increasing liquidity of securities markets, changes in attitudes to savings and investments etc.) lead to still more intensive enforcing and emphasis on targeting the effort to value making for the enterprise shareholders within the enterprise financial management. Not only (but especially) the owner or shareholders of an enterprise expect that the value of their investment in the enterprise will be at least preserved considering the inflation or in a more
favorable case it will be correspondingly increased (considering the taken risk and alternative possibilities they could have chosen and which they had given up because of the certain investment). Considering the historical development of the Czech economy where the financial and capital markets so far have not significantly developed as in other (mainly West countries), the Value Based Management concept (VBM) has not spread much yet. Mainly because of the need to increase the competitiveness of Czech enterprises on the financial markets and the success compared to massive foreign competition we can suppose that VBM concept will be more significantly used in the following decade.

The target to maximize the enterprise value formation for the involved groups in the enterprise (mainly shareholders, owners), should be achieved not only in short term but mainly in a long-term horizon. The financial theory has a lot of indicators in this regard (EVA, MVA, CFROI, Shareholder Value Added, etc.). Although each of them is specific the fact in common is that the enterprise creates value added and therefore it enhances the shareholder value (wealth of enterprise owners) if the investment return (profitability of invested capital) exceeds this capital costs [27, 35]. The further processed Economic Value Added concept is based on this idea, „rediscovery“ of residual income concept [9, 13, 26].

2.3 Economic Value Added

The measurement and evaluation of enterprise performance was for many years in the trend of using and liking the traditional indicators based on profit and variables derived from profit (see traditional financial analysis indicators). However in the last few years there has been a noticeable trend to reconsider existing used methods and tools, compare benefits and effectiveness of existing indicators, methods and conceptions with the modern ones. The selection of suitable indicators for enterprise performance measurement is not an easy matter and currently it belongs to the most discussed issues in enterprise management area. The classical indicators of traditional enterprise financial position and performance evaluation methods are based on elementary editing of data obtained from financial accounting reports, assess the capital profitability regardless the risk level which the investor takes. Their significant weakness is also the possibility to influence the level of reported profit (economic result) by legal accounting processes or deduction of trends from the past.

The essential difference and benefit of Economic Value Added concept compared to traditional indicators of enterprise performance measurement lies in two points:

- It introduces the idea of so-called opportunity costs (costs of a missed opportunity) into performance measurement which appear in the form of price, or capital costs (Weighted Average Costs Capital, WACC).
- It works with operating economic result (Net Operating Profit After Tax, NOPAT).

3 Problem Solution

Economic Value Added as an old-new concept of enterprise economic performance evaluation [14, 30] has come and still is coming through the verification process, assessing its suitability and benefits but also weaknesses. Especially the weaknesses of EVA concept are pointed out by e.g. [2], [6], [15], [20], [21] and others. As the most negative aspect of using and spreading EVA concept in enterprise practice it is seen the necessity to perform a lot of adjustments of information and data which were obtained from financial management reports and therefrom a considerable risk of result manipulation. The maximal amount of adjustments was numbered to 164 adjustments [31], and these were done for operative conversion reasons, financial sources conversion, tax conversion and shareholders conversion. All these were done with the target to:

- support decisions which will increase the enterprise value,
- adjust the data distortion which was caused by legal accounting processes,
- adjust the financing structures by items undetected in the enterprise balance sheet,
- define operating assets and related costs and revenues.

According to the annual list TOP 100 EVA in the Czech Republic [7] made by the Czech capital information agency of the Czech Republic (ČEKIA) for owners and shareholders it has been the most profitable in long term to invest in stakes in companies, such as ČEZ, Telefónica O2 a T-Mobile, ŠKODA AUTO, OKD, Continental HT Tyres etc. As author [26] states the managerial control system based on Economic Value Added has been implemented by tens large, publicly tradable companies including AT&T, Coca-Cola, Quaker Oats and others.
The research sample consists of one selected company. Company selection was based on the random sampling. According to NACE classification the researched enterprise belongs to middle sized enterprise, thus it employs more than 50 but fewer than 250 employees. It has worked in industrial production since its foundation. Head of the company is located in the Pilsen Region of the Czech Republic. It is one of the most important employers in West Bohemia.

Table 1 and Fig. 1 illustrate the results of Economic Value Added concept application (conversion accounting profit - EBIT, into economic profit) into the financial management of the selected enterprise, EVA levels which describes the creation or destruction of enterprise value.

The size of Weighted Average Cost of Capital (WACC), thus cost of capital corresponding with the level of income which investors expect for their investment in the enterprise (it is not real income but missed opportunity costs) and corresponding risk has been quantified according to a generally accepted formula:

\[ WACC = r_d \times (1-t) \times \frac{D}{C} + r_e \times \frac{E}{C} \]  

(1)

The basic model often used in Anglo-Saxon countries – Capital Asset Pricing Model (CAPM) will not be used for Return on Equity (ROE) quantification, but for the reasons of insufficiently liquid and allocation ineffective capital market of Czech economy it will be the Neumaiers’ method whose idea is supported also by the Ministry of Industry and Trade of the Czech Republic. The calculated interest rate is then just simple total of non-risk securities revenue [8] and risk surcharge.

\[ WACC = r_f + r_{LA} + r_{prod} + r_{FinStab} \]  

Table 1 – Results of the chosen firm’s case study - economic performance results comparison

<table>
<thead>
<tr>
<th>Indicator</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBIT</td>
<td>76984</td>
<td>77380</td>
<td>38531</td>
<td>12207</td>
<td>62078</td>
</tr>
<tr>
<td>WACC (%)</td>
<td>10,57</td>
<td>11,18</td>
<td>8,73</td>
<td>8,49</td>
<td>7,20</td>
</tr>
<tr>
<td>EVA</td>
<td>-43547</td>
<td>-69581</td>
<td>-46400</td>
<td>-61208</td>
<td>6473</td>
</tr>
<tr>
<td>ROE (%)</td>
<td>9,29</td>
<td>5,78</td>
<td>3,53</td>
<td>0,94</td>
<td>5,51</td>
</tr>
</tbody>
</table>

Source: own processing, 2013

Although the traditional financial performance indicators (accounting profit - EBIT, etc., ROE) show positive values currently they do not grasp the shareholder value creation and present a distorted image of the enterprise performance. However, we agree with the fact [9] that EVA concept should not entirely fully replace the traditional measures such as Return on Equity (ROE), Return on Assets (ROA) etc., inasmuch in they have incremental value in monitoring firm performance.

4 Conclusion
Current conditions of globalization request to develop and improve enterprise financial management. Although in the conditions of the Czech Republic there still prevails the classical approach to enterprise performance evaluation which is based on monitoring the traditional financial analysis indicators, continuously there has been a shift towards enterprise performance evaluation through value creation. These are new value criteria of Value Based Management concept which emphasizes maximization of value added for owners/shareholders. At present there are a lot of methods how to measure this value. In recent years the Economic Value Added (EVA) indicator has succeeded as its wide range of enterprise performance measurement has been „discovered“ by still higher amount of business entities in the Czech Republic and abroad. The results of EVA values long-term monitoring by business entities in the Czech Republic show that higher economic value added is generated by business entities of manufacturing industry and energetics. At present in enterprise practice EVA is applied as an enterprise economic performance management tool, method and concept. All activities (including investment) which the enterprise carries out in a certain period are assessed in relation with the enterprise value for owners (Shareholder Value). The results of the performed research including the results of the case study prove that enterprise performance evaluation on EVA basis takes the time factor and market risk into account and therefore provides a more accurate image about the enterprise financial performance. Further research will be oriented on comparison the situation (usage economic value concept in enterprise performance management) with CEE region or countries constituting the European Union. The paper was written within the SGS-2013-40 Paradigm of Development in the 21st Century and its Impact on the Behavior of Economic Entities project.

References: